

**STATEMENT OF BRUCE A. MORRISON**

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Chairman Kanjorski, Ranking Member Garrett, and Members of the Subcommittee, thank you for the opportunity to participate in this important hearing. Probing future options for Fannie Mae and Freddie Mac necessarily entails probing the future of housing finance policy for the nation.

I have been deeply engaged in issues of housing finance since the 1970s when I worked as a legal services attorney specializing in housing matters. This work continued in the 1980s as a member of this committee and in the 1990s as Chairman of the Federal Housing Finance Board, then regulator of the Federal Home Loan Banks. Since 2001, I have advised several financial institutions involved in housing finance.

There is a lot to learn from nearly 80 years during which the Congress and the Executive Branch have created and directed agencies and programs to enhance housing opportunities for Americans. But I would summarize that experience by saying that the overall trend has been a positive one in which housing opportunity has been greatly enhanced and the broader economy significantly benefited. However, that trend has been interrupted at least twice by spectacular failures—the savings and loan collapse of the 1980s and the current crisis fueled by the puncturing of an unsustainable housing bubble.

The overall success of the government's investment in housing opportunity, as well as the significant derailments that we suffered and are suffering, have both demonstrated that housing is so important to the nation's families and so central to our economy that government support for housing finance is not an option, but a necessity. A radical privatization agenda is neither wise policy nor a politically viable choice.

At the same time, both of our big failures in housing finance shared some important characteristics. They were sparked by regulatory choices that pushed things in the wrong direction. And when the signs appeared that things were going in the wrong direction, the responses only made things worse. It took actual hard landings, not managed changes, to get to the point of making corrections. And most important, a look backward revealed that structural arrangements in the housing finance system had made the crises almost inevitable.

Before the S&L crisis, savings banks and savings and loans provided the backbone of single family mortgage lending. Fannie Mae had its origins in the 1930s and was separated from the federal government in 1968 and Freddie Mac began as part of the Federal Home Loan Bank System in 1970 and

was sold to private shareholders in 1989. But despite these histories, the dominance of Fannie Mae and Freddie Mac in housing finance was a phenomenon of the 1990s with the collapse of one model—portfolio lending—and the explosion of another—widespread capital markets participation through securitization.

The point of this brief historical overview is to emphasize that the solution to one structural collapse can become the source of another. As the Congress decides how to redesign government oversight and participation in housing finance in the wake of the current crisis, it is best to avoid major departures from successful attributes from the past. It is better to concentrate on correcting what went wrong than at devising significantly altered arrangements, which will surely contain their own unintended seeds of future disasters.

For me, that suggests the following guides to the decisions the committee faces:

- **Both good politics and good social policy requires the federal government to provide structural and financial support to housing finance.** Yes, this is “credit allocation” different from what the market might do on its own, but it reflects the social and economic benefits that good housing brings to families and communities. From the 1930s forward, this role has been an overall success.
- **Government structural and financial support need not, and ought not, equate with government operational control, nor taxpayer risk beyond catastrophic events.** Private capital and private markets have been as integral to the successes of the past as have been the structures of government support. Neither innovation nor efficiency are hallmarks of government operations and maximizing the role of private sector institutions in mortgage finance is of equal importance to providing the public sector framework.
- **Regulatory strength, independence, and expertise is essential.** Neither the Federal Home Loan Bank Board in the 1980s, nor OFHEO in more recent times, was up to the task of preventing the excesses of their regulated entities, nor did they have influence over other major participants in the mortgage markets. It is not enough to restructure the role of Fannie and Freddie. Housing finance oversight requires its own integration into the regulatory structure.
- **Risks inherent in financial transactions do not disappear because they are transferred or repackaged.** There is a difference between financial engineering that broadens and better allocates the bearing of different risks of long term lending instruments like mortgages, and the use of financial structures to obscure risks from the oversight of counterparties, investors and regulators.
- **Discussions of the future of Fannie and Freddie often blur the distinction between who owns them and what risks they bear as opposed to the risks borne by others.** A “privately owned” entity can shift most of the risks of its activities to the government and a “government owned” entity can transfer most of the risks of its activities to the market. It is essential in this process to define the structure of ownership of the enterprises separately from the structure of risk-bearing in the mortgage market.

These general observations lead me to the following specific conclusions and recommendations:

- **The functions of mortgage finance are not being changed.** There is origination (including underwriting), funding, holding (both in portfolio and through securitization), insuring and servicing. Fannie and Freddie have a role in all of these activities, but they are concentrated on funding, followed by securitizing and portfolio holding, and insuring. But there are also private entities (such as brokers, mortgage bankers, depositories, investment banks, mortgage insurers, and public and private investors) as well as public entities (FHA, VA, GNMA, HUD, and state housing finance agencies) engaged in various of these activities as well.
- **Fannie and Freddie brought dependable, nationwide funding, lending and underwriting standards, and penalty-free refinancing to the bulk of the market.** It was the markets from which Fannie and Freddie were excluded—subprime and jumbo—that fueled both the innovations and the abuses that contributed to the mortgage bubble.
- **The government (aka the taxpayer) always ends up with the catastrophic risk.** And the beneficiaries of the rescues extend beyond those the government initially insures (and charges for the insurance). So it is better to design the structure to acknowledge the catastrophic risk role of the government, limit it in depth to the truly catastrophic, and broaden it in scope to finance what will be required in a calamity.
- **A corollary is that the private sector role should be as broad as possible in taking all but the catastrophic risk.** However, this requires nimble and expert functional regulation that assures that the government entity understands the risk, prevents its expansion by clever private counterparties, and imposes the discipline that makes the catastrophic event rare—underwriting and lending standards, credit rating processes and entities, capital standards—sweeping in activities by their relationship to the mortgage market, not by the type of firm or product involved.
- **The central role of Fannie and Freddie that should be preserved is that of mortgage market facilitator.** They create and enforce standards for the interface between the originations in the primary market and the funding in the secondary market. They apply the guarantee that provides the secondary market with its breadth and depth of liquidity. But that guarantee can no longer credibly be an “implied” rather than “explicit” obligation of the federal government, nor need it cover as much of the credit risk for most mortgages as it has in the past. Properly rated structured bonds can assign risks to private insurers and investors with only the most severe events calling on the federal government, and then through reserves funded by guarantee fees.
- **This role does not require a large portfolio of mortgages or mortgage-backed securities.** Most of the portfolio accumulation in the past was driven by the arbitrage profits it generated. Market-maker portfolios may be needed. And there may be certain types of “affordable” mortgages and low and moderate income multifamily mortgages for which portfolio holdings are appropriate. The difference is that the portfolio size and scope would be driven by the GSE mission, not shareholder profit expectations.
- **The risks inherent in GSEs with that kind of critical, but more limited role, are much less than those of Fannie and Freddie in the recent past.** And much of the risk previously embodied in the GSEs will be distributed elsewhere in the financial system. But it will not go away. Mortgage market regulation needs to be a part of the reformed financial regulatory structure and the regulation

of the reformed GSE structure and remaining functions would be just one part of the mortgage regulator's duties. This does not dictate a separate institution, but it does demand a functional specialization within whatever regulator it resides.

- **The GSE role is essential to housing affordability for both single family and low to moderate multifamily.** The first priority is to make sure that the structure and operations serve this role. The desire for additional subsidies for low income housing, through Affordable Housing Programs and Housing Trusts, can be accommodated by contributions from the GSEs, but they should not be structured to encourage profitable risk taking that is unnecessary to the GSE basic mission. One way to fund affordable housing activities would be to make the GSEs tax exempt (as the Federal Home Loan Banks are) and divert a tax-equivalent amount of profits to the Housing Trust or similar entity.
- **It is possible to accomplish the described GSE functions through a variety of ownership structures.** And it is possible to envision them being carried out by one or several entities, rather than by just two. But the first question is whether the function can be properly performed by a purely private entity (like a financial services holding company or bond insurer) or by a fully government owned entity (like GNMA).
- **My conclusion is that the low risk, low return model that I envision to facilitate the mortgage market, support housing affordability, and distribute the limited government guarantee is not consistent with the demands of a third party shareholder entity.** The inherent conflict between mission and profit, which bedeviled Fannie and Freddie in recent times, would only be worse in a truly private structure with the power to distribute a federal guarantee.
- **Government ownership presents an alternative set of challenges, starting with the displacement of market judgments with political ones.** In addition, I believe that it is important to try to distinguish between the market facilitation role that should support the entire housing market and the explicit subsidy role traditionally played by GNMA and FHA, freed from the constraints to manage a balance sheet or make any particular return to retain private capital.
- **My preference is for a structure that harnesses private capital that can accept the low risk, low return model that best fits mortgage market facilitation.** This might be achievable through a public utility model, but it would require cost accounting and price regulation activities that do not currently exist. The return might need to be higher than ideal to minimize the burden on the mortgage market of the facilitation activities.
- **Cooperative ownership by mortgage originators seeking government guaranteed facilitation of capital market funding seems to hold the greatest promise for removing conflicts between the interests of shareholders and the mission of the enterprises.** Mortgage originators get the benefit of the conduit and guarantee functions of the GSEs and need only receive an adequate return to tie up capital in support of this activity, which they will measure on the overall costs and benefits of the activity. And by scaling capital contributions to levels of use will keep these interests aligned. Further, since the originators compete with each other, they have a market incentive to pass through the GSE benefit to their customers. This kind of cooperative capital structure has worked for the Federal Home Loan Banks as providers of low risk, low return products for the past 85 years.

- **There could be a single cooperative, or competing entities.** Competition is usually better than monopoly, so at least preserving Fannie and Freddie descendants seems wise. The Federal Home Loan Banks collectively might be authorized to establish a subsidiary to provide a third competitor.

This analysis leads me to the following specific recommendations:

- **Keep the Fannie and Freddie as privately capitalized, but closely regulated GSEs** with a narrow but critical public mission to impose standards and maximize liquidity to mortgage finance, including multifamily. Consider letting the Federal Home Loan Banks jointly form an affiliate to provide a third such entity.
- **Capitalize these GSEs through a cooperative structure** in which those who use the conduit provide the capital in proportion to that use.
- **Limit the GSEs to issuing securities backed by loans they buy with a government-backed guarantee** against and providing that guarantee on securities issued by others that meet appropriate underwriting and risk-bearing characteristics. Fees from the guarantee must provide reserves against the risk, fund the activities of the GSEs, and provide whatever affordable housing subsidies the Congress imposes.
- **Limit the scope of the guarantee to catastrophic loss** by imposing the maximum achievable private risk bearing through recourse (with necessary capital rule changes to align the capital charges with the risk retained rather than all the risks of the mortgage sold), mortgage insurance and properly regulated credit default derivatives, structured MBS (properly rated by independent and regulated ratings agencies). Think of bond insurers as a model.
- **Abandon arbitrary limitations on the size or credit quality of mortgages that can use the GSE conduit** to avoid the avoidance of the credit discipline that undermined the system most recently. If the GSE risk is limited to the catastrophic, the subsidy to jumbo loans is small and the benefit of keeping everything that can attract private risk-bearing inside the regulated structure. Most subprime still go to FHA and VA, with securitization by GNMA, but when private issuers are willing to compete within the GSE structure, everybody wins.
- **Rebuild a mortgage market regulatory capacity within the restructured financial regulatory system.** That means that the regulation of the GSEs should be coupled with oversight of mortgage activities by depositories, mortgage bankers, and investment banks, as well as coordinating with state regulation of brokers and insurers.

Thank you for the opportunity to present these observations and recommendations. I will be pleased to respond to questions from Members of the Subcommittee.